

To: Basel II NPR Public File
From: Allison Breault
Date: June 9, 2006
Re: Meeting of Banking Agency Staff with the European Banking Federation, the Institute of International Bankers, and the Institute of International Finance

On May 25, 2006, Federal Reserve staff met with representatives of the European Banking Federation, Institute of International Bankers, and Institute of International Finance (collectively, "International Banking Associations") to discuss the interagency notice of proposed rulemaking ("Basel II NPR") to implement a new risk-based capital framework based on the Basel Committee on Banking Supervision's ("BCBS") Basel II capital accord ("Accord"). Representatives from the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (collectively, "Agencies") were also present. Before the meeting, the International Banking Associations submitted a proposed agenda addressing various aspects of the Basel II NPR. This agenda is attached.

A representative from ABN AMRO Bank opened the meeting with a presentation identifying foreign banks' principal concerns with divergences between the U.S. Basel II NPR and the Capital Requirements Directive ("CRD") that will implement the Accord in the European Union. The slides used in this presentation are attached. The presentation highlighted a number of areas of U.S./EU divergence and asserted that these divergences would lead to competitive inequities, increased implementation burden for international banks, and validation difficulties for supervisors. The presentation asserted that many of these divergences arise because the CRD more closely tracks the BCBS revised framework published in July 2004 ("Mid-year Text") than does the Basel II NPR.

The International Banking Associations expressed particular concern that the definition of default in the Basel II NPR is markedly different from the definition of default in the Mid-year Text. Specifically, they expressed concern that the definition of default in the Basel II NPR would force banks with international operations to maintain dual systems because other countries implementing the Accord use the definition of default in the Mid-year Text. The International Banking Associations also expressed concerns about the availability and applicability of historical data given the new definition of default in the Basel II NPR and stated that most foreign banks now collect data using the 90-days past due standard in the Mid-year Text.

The International Banking Associations expressed similar concerns about the Basel II NPR's and CRD's divergence when instructing banks how to calculate exposure at default ("EAD") for an asset. However, they characterized these differing approaches for determining EAD as "different paths to the same destination" and were more sanguine about the resolution of this divergence through a policy of mutual recognition

by supervisors. The International Banking Associations also encouraged the Agencies to employ a flexible “use test” to determine compliance by foreign banks with the NPR.

In addition, the International Banking Associations sought clarification on how to calculate a foreign bank’s “floor-adjusted” risk-based capital ratio. They expressed concern that the NPR’s transitional floor calculations differed significantly in a conservative direction from the Mid-year Text. In addition, the International Banking Associations expressed concern that after the U.S. adoption of Basel IA, many foreign banks would be required to invest in duplicative systems.

The International Banking Associations also asked the Agencies to discuss the contours of Basel IA and to explain specifically why the Agencies chose not to adopt the standardized approach set forth in the Accord. In addition, the International Banking Agencies urged the Agencies to conduct a sixth quantitative impact study to assess the competitive impact of Basel IA. They also sought clarification on the Agencies would propose to implement the Pillar II requirement of the Accord – specifically in the areas of stress testing and board of directors involvement.

In addition, the International Banking Associations expressed concerns about the preamble statement that “the agencies will view a 10 percent or greater decline in aggregate minimum required risk-based capital ... compared to minimum required risk-based capital as determined under the existing rules, as a material reduction warranting modifications to the supervisory risk functions.”

Agency staff urged the RMA and its members to submit detailed written comments on the proposal.

A list of attendees is attached.

PROPOSED DISCUSSION TOPICS

*May 25th Meeting in Washington of the Institute of International Bankers, European Banking Federation and Institute of International Finance with U.S. Regulators
To Discuss Basel II Implementation Issues*

1. Individual Introductions and Brief Remarks from the private sector and the regulatory agencies. [30 minutes]
2. Concerns with Divergences between U.S. Basel II and Global Advanced Basel II. [55 minutes]
 - Shared Objectives
 - Areas of Divergence
 - Suggested Approach
 - Specific Issues with Default
3. Application of Basel II, Basel I or Basel I-A to U.S. Bank Subsidiaries of International Banks. [10 minutes]
4. Application of U.S. Advanced Method to Interim U.S. Bank Holding Companies of International Banks and their U.S. Subsidiary Banks. [15 minutes]
5. Application of Basel II implementation to the “Well Capitalized” requirement for International Banks to get/maintain Financial Holding Company (FHC) status including during the Gap Period. [15 minutes]
6. Calculation of the Floors for Basel II in the U.S. [10 minutes]
7. Pillar 2. [10 minutes]
- *****
- Coffee Break [15 minutes]
- *****
8. General Comments. [10 minutes]
9. Pillar 3 Disclosure Issues. [10 minutes]

10. Operational Risk.

[15 minutes]

11. Other Concerns with the NPR.

[15 minutes]

- **GAO report – what impact is it likely to have and how do the regulators see it fitting into the process.**
- **Trading book – how will the trading book rules be incorporated into the NPR?**
- **Concerns with the international implications of the limitation that aggregate bank capital in the U.S. cannot be reduced by more than 10%.**

***Concerns with Divergences between US
Basel II and Global Advanced Basel II:
The US – EU Case***

Barbara Frohn

Washington May 25, 2006



ABN-AMRO

WELCOME

- I. Introduction
- II. US – EU Issues
- III. What is the context of the divergence?
- IV. Divergence Areas (Main)
- V. Divergence Areas (Detail)
- VI. Specific Issues: Definition of Default
- VII. Proposed Approach
- VIII. Closing Statement

I. Introduction

Embracing the Principles established by the AIG

“I want to assure you that US Supervisors are sensitive to the need to coordinate their efforts. We will do our best to make compliance manageable for global banking organizations and to improve our coordination efforts with foreign supervisors. [...] However while we can strive to minimize the burden on regulated institutions, we cannot eliminate it.”

Susan Schmidt Bies, March 14, 2005 IIB Conference

“ We also want you to let us know any concerns you have about cross-border implementation. We would be grateful if you could be as specific as possible about your concerns, since that would greatly assist in the resolution of the issues.”

Susan Schmidt Bies, May 16, 2006 GARP Basel II & Banking Regulation Forum

II. US – EU Issues

The Capital Requirements Directive and the draft NPR clearly share the same objectives.

“to provide incentives for banks to develop and use better techniques for measuring and managing their risks”

and underpin the same principles... **HOWEVER**

II. US – EU Issues

.....they do not always take the same route. Leading to, for some areas, irreconcilable differences,



“ Many roads lead to Rome.....”

Contrary to Basel I, the detail in Basel II and the way it is transposed into respective capital adequacy regulations, prevents one single approach for US assets.

Convergence is in the interest of all stakeholders

“ Over time, the Agencies expect that industry and supervisory practices likely will converge in many areas , thus mitigating differences across countries. Competitive considerations, both internationally and domestically, will be monitored and discussed by the Agencies on an ongoing basis. “

Draft NPR, p.89

Is it feasible in the current set up?

III. What is the context of the divergence?

CRD: Outlines detailed, prescriptive stipulations and/or preferential treatments for subject areas (e.g. eligibility and operational criteria for collateral; listing of covered bonds), **and** *pursuing the 'single market' objective*.

DRAFT NPR: In some areas more principles based; unambiguous definitions, shifting certain processes to Pillar 1 (e.g. supervisory mapping function ELGD).

....in some areas the draft NPR is more explicit - conservative than the CRD (e.g. treatment of defaulted assets), in others the draft NPR provides leniency (e.g. unfunded credit protection, asset based lending, non eligible retail guarantees).

EU Legislation is finalised. - US Legislation in last Consultative Stage

- CRD changes can only be incorporated after negotiated in a sitting of the European Parliament – may cause long delays or worse.

IV. Divergence Areas (Main)

Criteria for classification as 'main':

- Level Playing Field;
- Implementation burden;
- Validation repercussions.
 - Definition of Default;
 - Supervisory Mapping function de facto leading for most banks to an 8% LGD floor; $LGD < \text{or equal ELGD}$
 - EAD – LGD *definitions* and *floors*;
 - Prompt Corrective Action; 10% floor on lowering of required capital
 - Treatment of defaulted assets;
 - Treatment of intra group exposures.

V. Divergence Areas (Detail*)

- Asset Securitisation: Scope / asset types - Hierarchy of approaches;
- Equity: 'non significance': number of available approaches, floor calculations under IMA method on a portfolio vs. individual exposure level; hedging formula
- Specialised lending - HVCRE;
- Treatment of exposures to SME;
- Treatment of leases;
- Eligibility / operational criteria for collateral;
- Supervisory haircut percentages;
- Asset based lending.
- Retail definition - application of threshold
-

* This list is non-exhaustive; upon further analysis some of these may be reclassified as 'main'

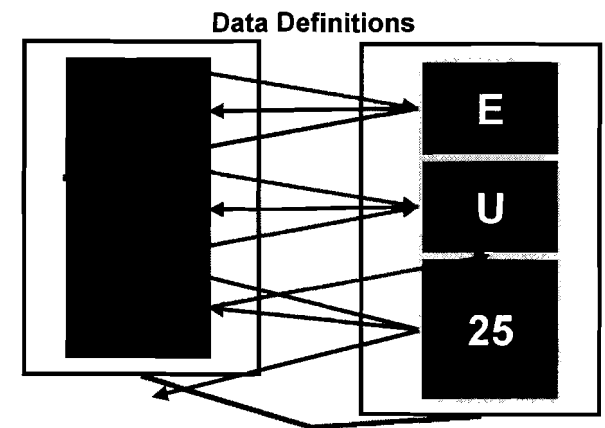
V Divergence: Repercussions

Although the implementation burden of a duplicative effort is extensive, timely and costly, more is at stake than the burden alone:

- Reconciliation between home and host reporting, including
 - internal and external reporting
 - Home solution and Host solution

N.B. existing consolidated group models often based on generic, firm wide, data definitions

- Duplication of effort (data information storage; analysis and data quality)
 - Multiple data definitions
 - Data history
 - Lack of transparency
- Incentives for change in Business Practices



V Divergence: Why irreconcilable?

Draft NPR (p. 104):

“The proposed rule requires that the systems and processes that a bank uses for risk-based capital purposes must be sufficiently consistent with the bank’s internal risk management processes and management information reporting systems such that data from the latter processes and systems can be used to verify the reasonableness of the inputs the bank uses for risk-based capital purposes”

And:

“Each legal entity must ensure that risk parameters and reference data are representative of its own credit and operational risk exposures”

VI. Specific Issues: definition of default

- The definition of default as stipulated in the draft NPR deviates from the reference definition in the CRD.

Repercussions for banks are severe:

- It leads to a situation in which two definitions of default are used within one bank;
- It leads to a double implementation effort;
- Strictly adhering to the CRD and to the NPR, it leads to a double validation effort and exacerbates the Low Default Portfolio issue.

VI. Specific Issues: definition of default



(2) Wholesale. (i) A bank's obligor is in default if, for any wholesale exposure of the bank to the obligor, the bank has:

- (A)** Placed the exposure on non-accrual status consistent with the Call Report Instructions or the TFR and the TFR Instructions Manual;
- (B)** Taken a full or partial charge-off or write-down on the exposure due to the distressed financial condition of the obligor; or
- (C)** Incurred a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category.



ANNEX VII Part 4: (44) A 'default' shall be considered to have occurred with regard to a particular obligor when either or both of the two following events has taken place:

- (A)** The credit institution considers that the obligor is unlikely to pay its credit obligations to the credit institution, the parent undertaking or any of its subsidiaries in full, without recourse by the credit institution to actions such as realising security (if held).
- (B)** The obligor is past due more than 90 days on any material credit obligation to the credit institution, the parent undertaking or any of its subsidiaries.

- In the EU non-accrual and provisioning are not the only driving force of default (unlikeliness to pay; breach of covenants, not waived).
- EU and US practices differ: In the US non-accrual and provisioning are not necessarily simultaneous; in the EU they almost always coincide
- In both cases, disparity between accounting standards and RC treatment

VI. Specific Issues: definition of default

Compared to EU, in the US one expects lower PDs, higher LGDs, pre-default forced reimbursements presumably have a higher impact

- One Obligor, One Rating;
 - one counterparty has exposure with a bank in its US operation; and
 - in a non-US booking office of the same bank.
 - Cross default provisions in loan documentation (sovereign bonds; syndicated loans)
- Cross border rating (model) validation;
- Mapping to external ratings;
- Use test considerations;
- EC: correlations between counterparties and ensuing risk categories
- Due to threshold) frequent transfer from Retail to Wholesale categorization not accommodated in a bifurcated approach to default;

VII. Proposed Approach

EU Banks respectfully ask the US Agencies, in their supervision efforts of the US subsidiaries of EU based Banks, to:

- Continue their standing practice of engaging in an active dialogue with the respective EU home supervisors;
- Thereby striving for supervisory convergence to the greatest extent possible;
- Whilst respecting the EU bank's legal obligation to comply with the Capital Requirements Directive as transposed into Member State Law;
- With consideration of the stated objective to align internal risk based capital models and approaches (EC) with the Regulatory Capital Adequacy approaches

VII. Proposed Approach

And to further, in case of remaining discrepancies between regulations,

- Take a “holistic” – principles based approach (“substance over form”);
- Apply the principle of mutual recognition;
- Or, exceptionally, by imposing US stipulations as ‘super equivalent’;
- And find solutions on a bilateral basis between bank and US Agencies
- Thereby applying the principle of proportionality to small US subsidiaries of EU banks.

*.....THE SAME MESSAGE HAS BEEN CONVEYED TO THE EUROPEAN COMMISSION,
CEBS, as well as TO THE EU REGULATORS.*

VIII. Closing Statement

“EU Banks are fully appreciative of the US Agencies’ efforts, and look forward to a continued cooperation and dialogue”



**Representatives of the European Banking Federation,
Institute of International Bankers and
Institute of International Finance
Attending the Meeting in Washington with U.S. Regulators**

May 25, 2006

Office of Thrift Supervision
1700 G Street, NW, Amphitheater 2nd floor

ABN AMRO Bank

Barbara Frohn, *Senior Vice President, Group Risk Management*
Alexander Reeders, *Basel II Program Manager*

Barclays Bank PLC

Kris Bhattacharjee, *Director, Global Regulatory Reporting*
John Whittaker, *Operational Risk & Basel II Program Director*

BNP Paribas

Christian Lajoie, *Senior Vice President – Basel II Group Coordinator,
GRM Group Risk Management*

Bundesverband deutscher Banken

Ulrich von Kenne, *Managing Director Competition Policy & Banking*

Commerzbank AG

Thorsten Lauterbach, *Vice President, Risk & Finance*

Deutsche Bank AG

Richard Ferguson, *Managing Director, Treasurer of the Americas*

Federation Bancaire de L'Union Europeenne (FBE)

Sally Scutt, *Chairman of the FBE's Capital Adequacy Working Group and
Deputy Chief Executive, British Bankers' Association*
Uta Wassmuth, *Adviser*

ING Direct USA

Rick Meng, *Enterprise Risk Management*
Alexander Kenneth Scott, *Enterprise Risk Management*

Institute of International Bankers

Kenneth L. Bachman, *Institute Counsel (Cleary Gottlieb Steen & Hamilton LLP)*
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Caitriona O'Kelly, *Policy Advisor*
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RBC Financial Group

Lyn McGowan, *Basel Program Business Head*

The Royal Bank of Scotland

Len Sinclair, *Head of Group Risk Management Operations and Basel II*

UBS

Per Dyrvik, *Managing Director*

Mattia Rattaggi, *Executive Director*

West LB AG

Stephen Kloock, *Managing Director & Head of Credit Risk Management, Americas*

Other Attendees**Delegation of the European Commission**

Crispin Waymouth, *First Secretary (Trade)*

London Investment Banking Association

Katherine Seal, *Director*

Banking Agency Staff**Federal Reserve Board**

Barbara Bouchard

Coryann Steffansson

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